

# Reimposable Discounts and Medieval Contract Penalties

By James P. George\*

[T]he suspicious word “penalty” will be avoided by the scrivener; the obligation will be for “lawful money” and the condition for the payment of a “just sum” or “full sum,” as local practice dictate;

—from *The Young Clerk’s Guide* (1670)<sup>1</sup>

## I. The Reimposable Discount

Penalty damages in contract—contrary to Anglo-American law since the late Middle Ages—ironically are common as reimposed discounts in modern consumer contracts. The reimposable discount is a late-twentieth-century sales scheme that combines legal puffery with illegal penalties. These pitches are used to sell furniture, appliances, cell phones, cars, to rent apartments, and to promote elective eye surgery. The offers are tempting and often heavily marketed in the media.

The common premise is that if the buyer acts now, the seller will discount the good or service by reducing the price, or by postponing the first payment and waiving interest payments during

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<sup>1</sup> See William H. Loyd, *Penalties and Forfeitures Before Peachy v. The Duke of Somerset*, 29 HARV. L. REV. 117, 121-22 (1915).

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that period. Reimposable discounts mimic true discounts with these enticements. If the buyer breaches—either a fundamental breach or in some cases a minor breach, such as late payment—then the discount is reimposed as stipulated damages, or sometimes as an alternative purchase price.

In general, consumer penalties seldom are challenged and rarely litigated. This leads to two significant negative impacts: one suffered by the public in general, and the other by the unfortunate breaching buyer. The first negative impact is illustrated by Congress's recent move to make bankruptcy more difficult to obtain—the so-called Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.<sup>2</sup> Whatever the validity of Congress' view that consumers should be held more responsible for their debts, it is obvious that additional penalties unrelated to sellers' losses are unfair. What is worse, these penalties unnecessarily compound consumer debt and multiply insolvencies.

The second impact, however, is more subtle. Contract penalties have returned to common use at the same moment that tort penalties are in retreat—under attack from both legislatures and courts.<sup>3</sup> At first glance these seem to be offsetting trends, but the opposite is true. Consumers injured by faulty products or incompetent service providers have fewer remedies. Meanwhile, consumers in breach of contracts increasingly are faced with substantial penalties. These penalties hide under the guise of reimposed discounts, or contractually-stipulated damages.

This is not to condemn true liquidated damages. Reasonable stipulations as to actual losses are both legal and economically efficient—even in pre-printed form contracts that are entered without negotiation. In addition to their widespread legal acceptance, liquidated damage clauses advance important social policies by providing fuller remedies for sellers and service providers. When

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<sup>2</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

<sup>3</sup> See, e.g., Texans for Lawsuit Reform, <http://www.tortreform.com> (last visited Oct. 2, 2007); See also, George C. Freeman, Jr. & Makram B. Jaber, *Further Progress in Defining Constitutional Constraints on Punitive Damages and Other Monetary Punishments*, 61 BUS. LAW. 517 (2006) (discussing judicial restrictions under constitutional clauses), and Arthur H. Bryant, *Access to Justice at Risk*, NAT'L L.J. March 28, 2005, at 22 (for examples of existing and proposed federal legislative restrictions on state tort remedies). See generally James P. George, *Access to Justice, Costs, and Legal Aid*, 54 AM. J. COMP. L. 293 (2006).

litigation is necessary, moreover, they tend to reduce trial costs by sidestepping proof of quantified damages.

What is not legitimate, however, is the stipulation of money damages not directed to any contractual loss—direct, indirect, consequential, administrative, or otherwise. The law has not changed in this area in more than four hundred years. In spite of this, unlitigated penalties are now pervasive in consumer transactions.

After recounting the ancient and ample precedents barring contract penalties, this article focuses on two examples of contemporary contract penalties with slightly differing sales pitches: new car sales and apartment rentals. Both examples demonstrate that these penalties run afoul of pervasive common law and statutory rules, as well as contemporary economic arguments favoring stipulated damages. The article concludes with a short discussion of why these issues are not being litigated.

## **II. The Contract Penalty in Anglo-American Law**

Contract penalties, and specifically their illegality in the Anglo-American legal system, have a long and fascinating pedigree. History, of course, becomes irrelevant if the law has significantly evolved or been entirely rejected. The ban on penalties has not. It is one of the oldest rules in Anglo-American law. The underlying policy reasons remain the same. Indeed, the rule's age and durability are ironic in light of the current consumer market's growing disregard. The discussion begins with a general sketch of early contract law, the Roman *stipulatio*, and the medieval English contract under seal. It concludes with a discussion of the bar in contemporary contract law. The rule's fashioners include Lord Mansfield, Sir Thomas Moore, Justice Story and Judge Posner, with social commentary from William Shakespeare.

### **A. Antiquity, Rome, and England**

Legal history suggests an inverse relationship between the use of contract penalties and the progress of social and legal systems: the growth of legal systems is the decline of penalties. The nature of contract law before the ascendancy of the Roman Empire is unclear, but scant evidence suggests that penalties were the exclusive contract remedy. The likely beginning of legal involvement in contract disputes was the advent of the executory contract, that is, the contract based on an agreement involving future performance by one or both

parties.<sup>4</sup> In non-executory contracts—those completed on the spot—remedies were needed only for non-conforming goods, and history offers little evidence of legal resolutions for these disputes.<sup>5</sup> These earliest executory contracts were based entirely on formalities. If the contract was in the proper form, often dictated by religion, it was enforceable and the only concern was compelling performance. This was done at first by religious sanctions, some as severe as excommunication. These eventually gave way to governmental sanctions. The simplest were fines and the most severe were the withdrawal of the law's protection. Another source of sanctions: those enforced by guilds and voluntary associations such as those formed by merchants. These penalties often outweighed the promisee's actual loss, but had the advantage of promoting peaceful settlements.<sup>6</sup>

The influence of these pre-Roman legal systems is unclear, but whatever Rome may have drawn from them, the penalties continued. Increasing trade in the growing Roman Empire resulted in more use of executory agreements, where a party offered consideration in exchange for the later delivery of goods. Lenders

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<sup>4</sup> See generally 1 WILLIAM HERBERT PAGE, PAGE ON THE LAW OF CONTRACTS 3-5 (2d ed. 1920). American contracts treatises tend to begin with the Roman Empire and ignore prior systems. Professor Page briefly addresses pre-Roman systems but cites only two sources. *Id.* at 4. Discussing contracts' legal evolution, Page describes the two executory contracts that we recognize today—the fully executory contract based on a formal promise with performance yet to come from both sides, and the partially executory contract where performance has been rendered by one side, creating an obligation for the other side. *Id.* The significance in Page's distinction is that the fully executory contract, that is, a promise with no performance from either side, drew its obligation from a religious base rather than what we would recognize as legal obligation; and, furthermore, it had religious sanctions as remedies. *Id.* See also 1 E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 1.4, at 11-13 (3d ed 2004). Sir Henry Maine's well-known treatise offers little more on pre-Roman contracts than speculation that prior to the Roman Empire, various jurisdictions' laws of contract were merely rudimentary attempts to resolve disputes among equals because inequals could not have mutually-enforceable agreements. See HENRY SUMNER MAINE, ANCIENT LAW 312-14 (Transaction Publishers, 2002) (1866). These accounts of pre-Roman contract law are further supported in non-legal historical references. See e.g., *Contracts*, 15 ENCYC. BRITANNICA 340-41 (2003).

<sup>5</sup> See PAGE, *supra* note 4, at 2-3 (contrasting the relatively sophisticated purpose of the modern legal system in rendering justice with the primitive legal system's goal of maintaining peace and avoiding violent remedies that occur outside a legal system).

<sup>6</sup> *Id.* at 3-5.

often financed these trade ventures, leading to the use of penalties for late payments. The perceived severity of those penalties led in turn to the development of usury laws, and with lawyers' help, the circumvention of usury laws by creative drafting and alternative penalties.<sup>7</sup>

Penal clauses, which became popular to ensure performance for a variety of acts and forbearance, were used in more than credit transactions. They took the form that we might recognize as bonds, and in fact were later termed "penal bonds" in England.<sup>8</sup>

Roman law developed three forms of contracts, with penalties most commonly associated with the stipulation contract.<sup>9</sup> *Stipulatio* was a written agreement to pay a fixed sum. In performing the relevant act, however, the agreement released the promisor from the obligation. The amount of stipulated money had no limit other than the will of the parties. Roman courts would enforce it in full, even where it exceeded the value of the act or forbearance.<sup>10</sup> Even the Romans later saw the need to modify this practice and limit the award to actual damages, at least in some cases.<sup>11</sup> Often the agreement required the obligor to perform by a certain date. In some instances, such as with agreements for the use of land, the parties simply attached the time element to the term of the lease.<sup>12</sup> For lending transactions, *stipulatio* circumvented the usury ban by requiring a penalty if the money were not repaid by a fixed date. It was often no

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<sup>7</sup> "The rapid spread of this form of obligation is explained by the fact that it was well adapted to evade the canonical prohibition of interest on loans, regarded as usury and therefore unlawful for a Christian, and that by the time interest was made lawful it had become firmly established as a common form of conveyancing." Loyd, *supra* note 1, at 119.

<sup>8</sup> See 3 FARNSWORTH, *supra* note 4, § 12.18 at 302-03; Loyd, *supra* note 1, at 119, 122.

<sup>9</sup> The other two forms of contract were "real" and "consensual." Real contracts were partly executed and the promisor's obligation arose not from the promise but the prior performance by the promisee. Consensual contracts were purely executory and thus based on the parties' exchange of promises. Both real and consensual contracts lacked the formalities of the *stipulatio*. See 1 FARNSWORTH, *supra* note 4, § 1.4, at 11-13.

<sup>10</sup> See Loyd, *supra* note 1, at 117 n.2 (citing JUSTINIAN, INSTITUTES, 3, 15, 7 (Moyle's 5<sup>th</sup> ed.); Dig. 4, 8, 32; 21, 2, 56).

<sup>11</sup> *Id.* at 117-18 n.3 (citing HUNTER, ROMAN LAW, 652, citing Dig. 44, 4, 4, 3).

<sup>12</sup> See 3 FARNSWORTH, *supra* note 4, § 12.18 at 302. It is unclear at what stage the use of sureties became common, and *stipulatio* was also apparently used to bind the third party surety in addition to or instead of the obligor. *Id.*

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defense that the debtor was detained in his journey to the creditor's home or otherwise paid a few days late. As with the earlier practice, the penalty was often strictly enforced.<sup>13</sup>

England, or Britannia during Roman times, was situated on the western edge of the pre-Columbian world and was primitive.<sup>14</sup> The Roman law of contracts faded in England when the empire failed, and England's primitive legal system developed these concepts anew.<sup>15</sup> Writings rarely evidenced executory contracts before the end of the thirteenth century. Most instances of enforcing agreements related to obligations to the king or other governmental figures.

With these exceptions, no writings guaranteed later performance or forbearance between private parties.<sup>16</sup> One reason may be the relative absence of purely private transactions in feudal kingdoms. In any event, the king's courts had the role of developing English contract law and were not inclined to adjudicate purely private agreements.<sup>17</sup>

To the extent that private parties entered unwritten executory agreements (or written agreements out of form), at least three sources made available remedies outside the king's judicial system: ecclesiastical courts applying canon law, commercial courts applying law merchant, and eventually equity courts. The remedies there, as with earlier primitive systems, included penalties to induce performance rather than damages for breach.<sup>18</sup>

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<sup>13</sup> See Loyd, *supra* note 1, at 119 nn.8-12. For civil law jurisdictions in Europe, the Roman practice has continued into the twentieth century, allowing for contractual penalties but with some jurisdictions authorizing the courts to modify the penalty if disproportionately high. *Id.* at 118 nn.3-7.

<sup>14</sup> See 1 FARNSWORTH, *supra* note 4, §1.5 at 13.

<sup>15</sup> See *id.*

<sup>16</sup> Up to the late 1200s, court-enforced penalties typically involved agreements under which a penalty was to be paid to the king, the sheriff, or to Westminster Abbey "for the relief of the Holy Land." See Loyd, *supra* note 1, at 119 n.9 (citing 2 POLLOCK & MAITLAND, 224; John of Oxford's form book, 7 LAW QUART. REV. 65, displaying a penal bond from the year 1274).

<sup>17</sup> "[I]t is not the custom of the court of the lord king to protect private agreements, nor does it even concern itself with such contracts as can be considered to be like private agreements." 1 FARNSWORTH, *supra* note 4, §1.5 at 14 (quoting R. DE GLANVILLE, TREATISE ON THE LAWS AND CUSTOMS OF THE REALM OF ENGLAND, bk. 10, ch. 18 (G. Hall ed. 1965)).

<sup>18</sup> See 1 FARNSWORTH, *supra* note 4, § 1.5 at 13-17. As with earlier legal

Two developments eventually brought change. One was England's increased trade with other Europeans. Trade necessarily involved executory agreements, and often required financing which came from European lenders who insisted on penalties for late payment.<sup>19</sup> The second development was the increased use of wax seals in a practice based on the Roman *stipulatio*. The wax seal is an ancient means of validation, essential in the days when illiteracy was high. Seals were common in Roman law, but England had been slow to adapt.

At the time of the Norman Conquest, only the highest English nobles and royalty possessed seals.<sup>20</sup> They used seals to signify not only the noble's declarations, but also obligations that we would now consider private. They used them for royal decrees and simple correspondence where the seal's function included both sealing the envelope and authenticating the source.<sup>21</sup> Seals thus provided widely-accepted proof of consent and authenticity and were ultimately adopted by a wider audience.

The increasing popularity of wax-sealed agreements resulted in better evidence, and allowed courts to enforce onerous remedies with greater confidence. As the adjudication of private agreements increased, the remedies for breach were bound up in the common law

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systems (*see supra* notes 4-13 and accompanying text), canon law enforced contracts through religious sanctions including excommunication. *See id.*

<sup>19</sup> *See* Loyd, *supra* note 1, at 119. *See also* 2 SIR FREDERICK POLLOCK & FREDERIC WILLIAM MAITLAND, THE HISTORY OF ENGLISH LAW: BEFORE THE TIME OF EDWARD I 225-26 (2d ed. 1959). This conclusion is best illustrated with the point that, in that pre-Columbian times, Venice was the center of European trade while relatively primitive England lay on the western edge of that world.

<sup>20</sup> The English use of seals contrasted from that in other kingdoms at that time. "In the France of Bracton's day the privilege of using a seal was confined to 'gentixhomes'; a man of lower degree would execute his bond by carrying it before his lord and procuring the apposition of his lord's seal. [footnote omitted] But in England, as we have often seen, the law for the great became the law for all, and before the end of the thirteenth century the free and lawful man usually had a seal." POLLOCK & MAITLAND, *supra* note 19, at 223-24. In spite of England's slow acceptance of seals for routine transactions, seals were essential for public records prior to the Norman Conquest. *Id.* at 223.

<sup>21</sup> *See History—Sigillography*, 20 ENCYC. BRITANNICA 611-13 (2003); *Contracts*, 15 ENCYC. BRITANNICA 341, 343 (2003). For online reference, *see Seals*, ENCYC. BRITANNICA (2006), <http://www.britannica.com/eb/article-9066471>. RESTATEMENT (SECOND) OF CONTRACTS § 96 cmt. a (1981); BLACK'S LAW DICTIONARY 1376 (8th ed. 2004). *See generally* SIR HILARY JENKINSON, GUIDE TO SEALS IN THE PUBLIC RECORD OFFICE (London, Her Majesty's Stationary Office, 1954).

forms of action. The penal remedy was linked in particular to the action of covenant, which by the mid-fourteenth century required a wax-sealed instrument.<sup>22</sup>

Penalties became especially popular for easements, rights of pasturage, and feudal tithes. In many cases, penalties were connected to borrowed money or other instances of credit and, accordingly, ran into the developing concepts of usury.<sup>23</sup> But penalties in non-lending agreements did not encounter the usury bar and their practice became common.<sup>24</sup>

The use of sealed agreements in England eventually acquired enormous significance. By the fourteenth century, a contract under seal could be enforced on its face with no showing of the elements of contract or the presence of consideration.<sup>25</sup> The result in some cases: the automatic enforcement of penalties verbatim, even for the slightest noncompliance with the terms of contract.<sup>26</sup> Unfair results led to negative judicial reaction and reform. England's reaction to large and powerful European banks may also have contributed. Negative reaction occurred outside the legal system as well, best highlighted by Shakespeare's social comment with the pound of flesh demanded in *The Merchant of Venice*.<sup>27</sup>

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<sup>22</sup> See 1 FARNSWORTH, *supra* note 4, § 1.5 at 15-16.

<sup>23</sup> Loyd, *supra* note 1, at 119-21.

<sup>24</sup> The English penal bond was a sealed instrument with a promise to pay a stated sum, further providing that this promise was null and void if the promisor rendered the required performance. 3 FARNSWORTH, *supra* note 4, § 12.18 at 302. Farnsworth notes that this is similar to the still-used third party surety. It differs, however, in the amount obligated. Common law courts enforced penal bonds strictly and literally according to Farnsworth. If, then, the promisor did not meet every obligation under the contract, the common law courts would render judgment on the penal bond, regardless of the amount of loss suffered by the promisee. This had the effect of securing contract performance by making breach entirely unacceptable because of the resulting high penalty, a so-called *in terrorem* effect. *Id.* at 301.

<sup>25</sup> THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 633-34 (5th ed. 1956). Consideration was unknown at the time and did not set in until *Slade's Case* in 1602. *Id.* at 645-51.

<sup>26</sup> 3 FARNSWORTH, *supra* note 4, § 12.18 at 302.

<sup>27</sup> See WILLIAM SHAKESPEARE, *THE MERCHANT OF VENICE* act 1, sc. 3 (cited in POLLOCK & MAITLAND, *supra* note 19, at 225). See also Loyd, *supra* note 1, at 123 (observing that *The Merchant of Venice* "clearly indicates that the medieval mind was already, perhaps unconsciously, in revolt against the harshness, the excessive literalism of the law, of which the merchant's bond was but a symbol").

Doctrinal relief from penalties—their outright proscription—did not arrive until the equity courts began issuing injunctions in the sixteenth century. Anecdotal relief came centuries earlier from both law and equity judges who began denying penalty clauses as early as 1308. In *Umfraville v. Lonstede*, plaintiff brought an action in debt based on a writing that was supposed to have been delivered on a certain day.<sup>28</sup> The defendant pleaded that he had been away from home but had left the task to an agent, that he had subsequently offered to deliver the writing, that plaintiff had suffered no damage by the short delay, and that defendant was again tendering performance as part of his answer. When Plaintiff rejected the defense and the tender, Lord Chief Justice Bereford responded:

You demand this debt because the writing was not delivered and he says that before now he has tendered it, and that he tenders it now. Therefore it is well that you receive it. Moreover, this is not, properly speaking, a debt; it is a penalty, and with what equity . . . can you demand this penalty?<sup>29</sup>

Bereford's twelfth-century reasoning remains one of the rationales for rejecting contract penalties. The plaintiff may have profited more from the breach than from performance, thus motivating plaintiff to reject performance on any grounds, or in some cases to create circumstances favoring a breach.<sup>30</sup>

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See also Richard A. Posner, *Remarks on Law and Literature*, 23 LOY. U. CHI. L.J. 181, 183-85 (1991-92).

<sup>28</sup> Loyd, *supra* note 1, at 119 (citing to Y.B. 2 & 3 Edw. 2, *reprinted in SELDEN SOCIETY* 58). See also PLUCKNETT, *supra* note 25, at 677 (citing Y.B. Edw. 2, *reprinted in 2 SELDEN SOCIETY* xiii, 59). Bereford, a common law judge, was apparently using the term “equity” in a general sense, and not jurisdictionally.

<sup>29</sup> Loyd, *supra* note 1, at 119 (citing Y.B. 2 & 3 Edw. 2, *reprinted in SELDEN SOCIETY* 58). Bereford was a law judge, sitting eventually as Lord Chief Justice on the Queen's Bench. His use of the term “equity” is apparently generic rather than jurisdictional. This passage is alternatively reported as, “What equity would it be to award you the debt when the document is tendered and when you cannot show that you have been damaged by the detention. . . . Moreover this is not properly a debt but a penalty; and with what equity can you demand this penalty?” PLUCKNETT, *supra* note 25, at 677 (citing Y.B. Edw. 2, *reprinted in 2 SELDEN SOCIETY* xiii, 59).

<sup>30</sup> See generally Loyd, *supra* note 1, at 120-25. See also PLUNKNETT, *supra* note 25, at 677-78.

For several hundred years, then, the negative reaction to penal bonds from both law and equity was merely case-specific, and penalties remained in use. The task fell to the chancery courts to fashion the doctrines that ultimately barred the penal bonds and contract penalties in general.

The first categorical relief came at the beginning of the seventeenth century, in cases where the obligor had incurred the penalty through his own negligent or unintentional acts, and where the harm to the obligee was minor.<sup>31</sup> Sir Thomas Moore urged the next step, which interestingly enough involved claims for nonpayment of rent. The procedure allowed the defaulting tenant to seek relief from chancery, which would enjoin the landlord from enforcing the penalty and require him to take the claim back to law courts to determine actual damages.<sup>32</sup> The equitable remedies became common enough to compel their direct application in the law courts, accomplished both by changes in the common law and by statute.<sup>33</sup>

By the late seventeenth century, the English legal community had determined that society would be better served if contract breach was an available option, as long as the breaching party was prepared to pay the other's loss. Equity courts were the forum, and they began enjoining penal bonds, then sending the case to trial in common law courts to determine the actual damages. This in turn led to statutes in England requiring the penal bond obligee to state the promisor's breach and then show actual damages.<sup>34</sup> The practice later extended to a general bar of penal damages in contract.<sup>35</sup> These statutes came late enough and were sufficiently permanent that they applied to the American colonies, and were succeeded by new statutes after American independence.<sup>36</sup>

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<sup>31</sup> Loyd, *supra* note 1, at 124-25, and sources cited therein.

<sup>32</sup> Certainly by the time of the Restoration it could be said that, "[i]t is a common case to give relief against the penalty of such bonds to perform covenants, etc, and to send it to a trial at law to ascertain the damages in a *quantum damnificatus*." Loyd, *supra* note 1, at 125 (quoting from 1 EQUITY CASES 91 (abr.)). See also 3 FARNSWORTH, *supra* note 4, § 12.18 at 302.

<sup>33</sup> Loyd, *supra* note 1, at 126. See also PLUNKNETT, *supra* note 25, at 608.

<sup>34</sup> 3 FARNSWORTH, *supra* note 4, § 12.18 at 302.

<sup>35</sup> *Id.*

<sup>36</sup> Loyd, *supra* note 1, at 126 (citing S.D. Wilson, *Courts of Chancery in the American Colonies*, 19 AM. L. REV. 226). See also 3 FARNSWORTH, *supra* note 4,

**B. The American View**

The American colonies adopted English law piecemeal, and initiated several areas of reform. One reform promoted freedom of contract, encouraging the evolution of contracts with stipulated damages. Some met the definition of penalties, but even where the colonial courts enforced them, a rule of reason prevailed.

One example is *Tall v. Ryland*, a 1670 colonial opinion based on Tall's equitable action to enjoin a law verdict requiring him to forfeit a £ 20 bond.<sup>37</sup> Tall and Ryland were fishmongers with contiguous shops, and Tall had executed the bond as assurance that he would not disparage Ryland's fish.<sup>38</sup> Tall fell short of his pledge when he asked a customer why he would buy fish from Ryland, because Ryland's fish stunk.<sup>39</sup> Ryland sued on the bond and won.<sup>40</sup> Following the English procedure, Tall brought the equitable action to enjoin the penalty, but the chancery judge sustained Ryland's demurrer.<sup>41</sup> The equity court held that the bond related to an agreement "to preserve amity and neighborly friendship" and that Ryland had sustained damage for which £ 20 was a fair estimate.<sup>42</sup> In finding for Ryland, however, the judge noted that this was "not to be a precedent in the case of a bond of £ 100 or the like."<sup>43</sup>

In assessing this case's meaning, it is noteworthy that today Ryland would have a tort remedy for defamation or business disparagement, apart from the bond remedy. Because Tall and Ryland had already agreed on the bond and its terms, it is easy to understand why a court might find it enforceable. Assuming that this modern remedy was contemplated in a contract between the parties, the liquidated damages clause for £ 20 would likely be upheld today as a reasonable assessment of unquantifiable damages. Consistent with the law of today, the 1670 equity court stated in dicta that an

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at 302.

<sup>37</sup> Loyd, *supra* note 1, at 128 (citing and quoting 1 CASES IN CHANCERY 183 (1670), 1 EQUITY CASES 91 (abr.)).

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.*

<sup>42</sup> Loyd, *supra* note 1, at 128 (citing 1 CASES IN CHANCERY 183 (1670), 1 EQUITY CASES 91 (abr.)).

<sup>43</sup> *Id.*

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unreasonably high bond would not be enforced.<sup>44</sup> The unstated rule is that liquidated damages that are unreasonably high amount to a penalty.<sup>45</sup>

American law, both common law and statutory, has largely followed the English ban on contract penalties. In his seminal work *Equity Jurisprudence*, Joseph Story disputed views that questioned the courts' ability to interfere with stipulated damages: "There is no more intrinsic sanctity in stipulations by contract than in other solemn acts of the parties which are constantly interfered with by courts of equity upon the broad grounds of public policy on the pure principles of natural justice."<sup>46</sup> A century and a half later, Professor Farnsworth traced the American view from a three-element test for improper stipulated damages to a single principle of just compensation for actual damages.<sup>47</sup> American law reflects this conclusion in scores of cases and articles,<sup>48</sup> and the Supreme Court has recognized its application to federal government claims against private contractors.<sup>49</sup>

The most thorough explanation may belong to Judge Posner, writing as judge, but with his usual scholarly insight. *Lake River Corp. v. Carborundum Co.*<sup>50</sup> was a dispute in which a warehouse operator sought recovery of contractually-agreed damages for a manufacturer's breach of a distribution agreement. The product was

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<sup>44</sup> *Id.*

<sup>45</sup> Loyd, *supra* note 1, at 129 n.50 (citing several cases on this point from 1674 through 1891).

<sup>46</sup> *Id.* at 126 (quoting 2 JOSEPH STORY, EQUITY JURISPRUDENCE § 1316 (13th ed. 1886)).

<sup>47</sup> The original three elements justifying liquidated damages were that (1) the damages must be uncertain or difficult to prove; (2) the parties must intend to liquidate them in advance; and (3) the stipulated amount must be reasonable. 3 FARNSWORTH, *supra* note 4, § 12.18 at 305 (discussing *Banta v. Stanford Motor Co.*, 92 A. 665 (Conn. 1914)). Farnsworth explains that an increased emphasis on contracting freedom and the development of the doctrine of unconscionability led to the de-emphasis of the first two elements, leaving the lone element of just compensation. *See id.*

<sup>48</sup> *E.g.*, *Sun Ridge Investors, Ltd. v. Parker*, 956 P.2d 876 (Okla. 1998); *Flores v. Millenium Interests, Ltd.*, 185 S.W.3d 427 (Tex. 2005); *Raffel v. Medallion Kitchens of Minn., Inc.*, 1996 WL 675787 (N.D. Ill. 1996). *See generally* 3 FARNSWORTH, *supra* note 4, § 12.18 at 300-23.

<sup>49</sup> *See Priebe & Sons, Inc. v. United States*, 332 U.S. 407 (1947).

<sup>50</sup> *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284 (7th Cir. 1985).

“Ferro Carbo,” an abrasive powder used in steel production. To better serve its midwestern customers, manufacturer Carborundum asked that Lake River, operator of an Illinois warehouse, serve as distributor. In the resulting contract, Lake River was to receive Ferro Carbo in bulk, package it in bags, and ship the bags to Carborundum’s customers. Carborundum would retain title until delivery to the customer. To package the Ferro Carbo, Lake River had to install a new bagging system at a cost of \$89,000. To ensure recovery of this cost and the agreed-to profit of twenty percent, Lake River negotiated a minimum-quantity guarantee of 22,500 tons over a three-year period. That clause further stated that if the minimum quantity was not shipped at the end of the three-year term, that Lake River had the right to invoice Carborundum for the difference between the quantity bagged and the minimum guaranteed.<sup>51</sup>

The parties signed the contract in 1979, but the price of steel soon dropped and when the contract expired in 1982, Carborundum had shipped only 12,000 of the promised 22,500 tons. Had the contract been performed in full, Lake River would have profited approximately \$553,000, and when the contract ended, it demanded the anticipated balance of \$ 241,000. Carborundum refused, arguing that this was not liquidated damages, but instead an unenforceable penalty. Making the case more litigable, Lake River still had 500 tons of Ferro Carbo with a market value of \$269,000, and it refused release until Carborundum paid the contractually-agreed damages. Lake River offered to sell the Ferro Carbo and place the funds in escrow, but Carborundum rejected that and instead trucked in its product for those customers, at an additional cost of \$31,000. Lake River sued in federal court for \$ 241,000, and Carborundum counterclaimed for conversion. The trial court found in both parties’ favor, that is, that Lake River was entitled to the contract damages of \$241,000 plus \$17,000 in prejudgment interest, but that Lake River in turn had wrongfully converted the inventory and owed Carborundum \$269,000 plus \$31,000 for the extra cost of shipping. Both parties appealed.<sup>52</sup>

Noting that Lake River had not been able to identify the type of lien it was asserting, Judge Posner likened it to an artisan’s or bailee’s lien, that is, one imposed on goods on which services had been rendered without payment. The court then held such a lien to be inappropriate under these facts because Carborundum had paid for all

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<sup>51</sup> *Id.* at 1286.

<sup>52</sup> *Id.* at 1286-87.

services up to that point. Its only breach had been the failure to ship the additional quantity to Ferro Carbo, to achieve the guaranteed minimum. Thus Lake River was holding the Ferro Carbo, not for payment of an existing debt, but, to pressure Carborundum into paying the liquidated damages on the Ferro Carbo that had not been shipped. In turn, Lake River had not incurred expenses in bagging or delivering the unshipped Ferro Carbo, a point that led to the court's conclusion that Lake River was pursuing a penalty.<sup>53</sup>

Turning to the damages issue, Judge Posner acknowledged an inclination to question whether the historic ban on penalty clauses was appropriate. This dicta produced two arguable policy reasons for upholding contractual penalties. First, parties agreeing to penalties for breach are providing an earnest of performance. The willingness to suffer a penalty that clearly exceeds actual damages enhances the promisor's credibility and may enable the promisor to enter contracts otherwise closed.<sup>54</sup> Second, penalty clauses may discourage both efficient and inefficient breaches. An efficient breach is one done purposefully in order to maximize the breaching party's gain because of conditions arising after the contract's creation.

Judge Posner used the example of a breach that will cost the breaching party \$12,000 in payment to the other party, but will earn the breaching party \$20,000 elsewhere. Even though efficient breaches are good in a macro-economic sense because they produce a net gain, they can be nuisances to some contracting parties. Penalty clauses that nullify the breaching party's gain help ensure specific performance without resorting to courts.<sup>55</sup>

Judge Posner explained the utility of penalty clauses by distinguishing efficient breaches from inefficient ones, with the latter defined as breaches costing the promisee more than the gain to the breaching promisor. Posner concluded that because compensatory damages are sufficient for inefficient breaches, the social utility of

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<sup>53</sup> *Lake River*, 769 F.2d. at 1287-88. The court further rejected Lake River's argument that contrary to the court's analysis, it had sustained actual damages in its purchase of the bagging equipment which now would have to be amortized over the sale of 12,500 rather than 22,500 tons of Ferro Carbo. The court found that not only did Lake River use the bagging equipment for other jobs, but that amortization was a mere accounting entry and need not reflect cash flows. In so holding, the court was not rejecting Lake River's claiming of that \$89,000 cost of the bagging equipment, but merely holding that Lake River would have to prove such damages conventionally. *Id.* at 1288.

<sup>54</sup> *Id.* at 1289.

<sup>55</sup> *Id.*

penalty clauses is limited to the deterrent effect on efficient breaches. Exceptions and counter-arguments exist here as well. One is that penalty clauses are justifiable because for all contracts, they enhance the promisor's credibility and thereby create access to otherwise unavailable contracts. A final Posner dictum—important to this article's point—is that

[p]arties (always assuming they are fully competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs—costs that include the possibility of discouraging an efficient breach somewhere down the road—and will include the clause only if the benefits exceed those costs as well as all other costs.<sup>56</sup>

Having made the argument for penalty clauses in some economic settings, Judge Posner then acknowledged that this economic view is not the law, not in Illinois and not in the US.<sup>57</sup> Under *Lake River's* legal summary, liquidated damages must be

[a] reasonable estimate at the time of contracting of the likely damages from breach, and the need for estimation at that time must be shown by reference to the likely difficulty of measuring the actual damages from a breach of contract after the breach occurs. If damages would be easy to determine then, or if the estimate greatly exceeds a reasonable upper estimate of what the damage are likely to be, it is a penalty.<sup>58</sup>

Applying the rule to the *Lake River* facts, Judge Posner acknowledged that the penalty/liquidated damages distinction is often difficult and rests on facts peculiar to each case. For *Lake River's* contract, however, the clause clearly was a penalty because it was

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<sup>56</sup> *Id.*

<sup>57</sup> “[W]e must be on guard to avoid importing our own ideas of sound public policy into an area where our proper judicial role is more than usually deferential. The responsibility for making innovations in the common law of Illinois rests with the courts of Illinois, and not with the federal courts in Illinois. *And like every other state*, Illinois, untroubled by academic skepticism on the wisdom of refusing to enforce penalty clauses against sophisticated promisors, . . . continues steadfastly to insist on the distinction between penalties and liquidated damages.” *Lake River*, 769 F.2d. at 1289 (emphasis added) (citations omitted).

<sup>58</sup> *Id.* (citing Illinois case law).

“designed always to assure Lake River more than its actual damages,”<sup>59</sup> a conclusion supported by a series of hypotheticals demonstrating Lake River’s loss at various times in the term of the contract. The clause failed to calculate that Lake River would gain by not having to incur its own performance costs, and instead guaranteed it a profit.

In reaching this conclusion, Posner carefully distinguished valid liquidated damages, using a case law example of an employment agreement that docked the employee four percent of his salary for early resignation, and did so in addition to the employee’s loss of the remaining months’ salary. This was a valid estimate of the damage to the employer in finding a replacement, Posner argued, even though the four percent measure will increase with higher-paid employees.

*Lake River* performs multiple functions in American jurisprudence. It explores the policy arguments for contracted-for penalties in limited settings, typically involving parties of equal bargaining power who are negotiating agreements in which guarantees or other features are especially important. It acknowledges that in spite of significant scholarly support for these arguments, American law has uniformly retained the English ban on contract penalties that cannot meet the test for liquidated damages. It articulates the liquidated damages test and provides a nuanced distinction between legal liquidated damages and illegal penalties posing as liquidated damages. But assuming full merit for Judge Posner’s arguments for the utility of penalty clauses, those arguments do not support their enforcement in adhesion consumer contracts consummated with little or no negotiation between parties of significantly disparate bargaining power.<sup>60</sup>

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<sup>59</sup> *Id.* at 1290.

<sup>60</sup> For a convenient summary of the scholarly analyses of contract penalties, see Avery W. Katz, *Remedies for Breach of Contract Under the CISG*, 25 INT’L REV. L. & ECON. 378, 386-87 (2005). Professor Katz’s discussion cites to articles for and against “supracompensatory damages” in both domestic and international commercial settings, with little if any application to consumer sales. These articles include Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes of an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 544 (1977); Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984); Philippe Aghion & Patrick Bolton, *Contracts as Barriers to Entry*, 77 AM. ECON. REV. 388 (1987); Tai-Yeong Chung, *On the Social Optimality of Liquidated Damages Clauses: An Economic Analysis*, 8 J.L. ECON. & ORG. 280 (1992); Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV.

To the extent that *Lake River* purports to examine the American rule on contract penalties, its ruling reflects only the common law. A complete review requires attention to statutory oversight of contracts, and there are countless examples in the US. Contracts have been somewhat regulated by statute since late medieval England, including one that codified the equity courts' requirement that contract damages be limited to the actual loss sustained.<sup>61</sup> This raises two important corollaries regarding consumer transactions. First, the Uniform Commercial Code's ("UCC") regulation of consumer sales echoes the common law rule barring penalties.<sup>62</sup> Second, some statutes impose penalties for

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33 (2003); Alan Schwartz, *The Myth That Promises Prefer Supracompensatory Remedies: An Analysis of Contracting for Damages Measures*, 100 YALE L.J. 369 (1990); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J.L. ECON. & ORG. 98 (1996); Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach, and Optimal Investment*, 86 AM. ECON. REV. 478 (1996); Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83 (1999); Avery W. Katz, *The Option Element in Contracting*, 90 VA. L. REV. 2187 (2004); Robert E. Scott and George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM L. REV. 1428 (2004). See also articles listed at 3 FARNSWORTH, *supra* note 4, § 12.18 at 303 n.8. For an article addressing adhesion issues in consumer contracts but not including penalties, see Omri Ben-Shahar, *"Boilerplate" Foundations of Market Contracts Symposium*, 104 MICH. L. REV. 821-1246 (2006) (generally discussing adhesion agreements with no focused discussion of penalty damages).

<sup>61</sup> See 3 FARNSWORTH, *supra* note 4, § 12.18 at 302-03.

<sup>62</sup> U.C.C. § 2-718 (2003). Section 2-718 was amended in 2003, with no substantive change regarding consumer contracts but easing the burden of proof for plaintiffs in commercial cases. As of the time of this publication, no states have adopted the amended version. However, this strikeout version, taken from the official text, reflects that the UCC's rule on liquidated damages has been consistent with the common law and did not change with the 2003 amendments. The standard and amended sections read:

Damages for breach by either party may be liquidated in the agreement but only at an amount ~~which~~ that is reasonable in the light of the anticipated or actual harm caused by the breach and, in a consumer contract, the difficulties of proof of loss, and the inconvenience or non-feasibility of otherwise obtaining an adequate remedy. ~~A term fixing unreasonably large liquidated damages is void as a penalty. Section 2-719 determines the enforceability of a term that limits but does not liquidate damages~~

Amended art. 2-718, 1 U.L.A. 549 (2004). Official Comment 2 to the 2003 version states in part: "Under original Section 2-718, a party seeking to enforce a liquidated damages term had to demonstrate the difficulty of proving the loss and the

breach with the intention of punishing the breach, but the legislative intent emphasizes that these penalties are exceptions rather than a trend away from the rule.<sup>63</sup>

Summarizing the law's view of contract penalties, the measure of damages for breach of contract is what the promisee would have received had the contract been performed. Contractually-stipulated damages are valid to compensate for real losses that are difficult to quantify. But stipulated damages not reasonably allocable to actual losses, but instead aimed at encouraging performance, are illegal.<sup>64</sup> Economists have questioned the Anglo-American rejection of penalties and have argued for their utility in limited contract settings involving parties of equal bargaining power. Legislatures and courts have rejected these arguments, but even if lawmakers heeded the economists, their arguments are not directed to the form-printed consumer contracts in which reimposable discounts lurk.

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inconvenience or nonfeasibility of obtaining an adequate remedy. These requirements have been eliminated in commercial contracts but are retained in consumer contracts." In other words, the 2003 insertion of "and, in a consumer contract" was intended to ease the burden of proof for plaintiffs in commercial contracts who were on a more even footing with the breaching defendant, but retain the higher burden for sellers in consumer contracts. Official Comment 3 explains that the penultimate sentence was stricken for redundancy. *See id.*

<sup>63</sup> See e.g., *Flores v. Millenium Interests, Ltd.*, 185 S.W.3d 427 (Tex. 2005) (construing TEX. PROP. CODE ANN. § 5.077 (Vernon 2006)). Two other Texas statutes treating "liquidated damages" as a penalty provision are TEX. LAB. CODE ANN. § 62.201 (Vernon 2006) (for violations of the minimum wage law), and TEX. AGRIC. CODE ANN. § 52.106(d)(1) (Vernon 2004) (allowing a marketing association to "fix as liquidated damages a specific amount to be paid by a member if the member breaches the marketing contract"). *Flores*, 185 S.W.3d at 432 nn. 4-5.

<sup>64</sup> See e.g., *Priebe & Sons v. United States*, 332 U.S. at 412-14; *Lake River*, 769 F.2d at 1290; *Sun Ridge Investors*, 956 P.2d at 878. The general principle that contract damages are measured by the non-breaching party's loss of expected profits is thoroughly established in American law. See 3 FARNSWORTH, *supra* note 4, § 12.8 at 190 ("One is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed"); *id.* at 301 ("Enforcement of [a penalty] provision would allow the parties to depart from the fundamental principle that the law's goal on breach of contract is not to deter breach by compelling the promisor to perform, but rather to redress breach by compensating the promisee."). Recent reaffirmations include *Coghlan v. Wellcraft Marine Corp.*, 240 F.3d 449, 453-54 (5th Cir. 2001) (construing Florida and Texas law); *Ex Parte Steadman*, 812 So.2d 290, 295 (Ala. 2001); *Siegel v. Laric Entm't Corp.*, 763 N.Y.S.2d 607, 608 (N.Y. App. Div. 2003); *Ford v. Trendwest Resorts Inc.*, 43 P.3d 1223, 1227-28 (Wash. 2002).

### III. Discounts and Other Purchase Incentives as Penalties

For as long as Anglo-American jurisprudence has opposed contract penalties, people with the upper hand in drafting contracts have conceived of stratagems to circumvent the ban. Ample case law reflects these attempts, mostly in commercial settings between parties of somewhat equal bargaining strength. These penalties have most often been disguised as liquidated damages.<sup>65</sup> The more clever drafters take advantage of the penalty/liquidated damages distinction by characterizing the damages as good faith estimates of the promisee's actual loss, highlighting the loss and the likely inability to ascertain that loss accurately. Courts have seen through this by ignoring labels and treating the contractual terms for their actual function and result.<sup>66</sup>

With clever drafting innovations, many consumer contracts today avoid characterizing the extra damages as penalties. Instead, they are characterized as discounts that can be reimposed upon breach. Such discounts appear in several forms. Among them: deferred payments, reduced interest on the underlying financial agreement, interest waivers, and discounts from a seller-established "market price" or "list price."

Of course, these practices also are purchase incentives, and in that function alone are perfectly legal even if somewhat deceptive.<sup>67</sup> It is the seller's reimposition of the discount upon breach that is illegal. Sellers can make a number of arguments to support the reimposed discounts. Two examples, however, illustrate the invalidity of those arguments—rent concessions in residential leasing, and new car sales with deferred payments and no interest during the deferred period.

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<sup>65</sup> See *Lake River*, 769 F.2d at 1288-91. See generally 3 FARNSWORTH, *supra* note 4, § 12.18 at 300-23, especially 302-05.

<sup>66</sup> See *Stewart v. Basey*, 245 S.W.2d 484, 486 (Tex 1952).

<sup>67</sup> All three examples—deferred payments, interest waivers, and discounts from manufacturer's list price—are nothing more than the seller varying the initially-offered sale price in competition with other sellers. These examples function as real discounts only where the seller is charging less than the price for which a commonly-transacted good is otherwise selling. If price competition is the motive, then the lowered "discount" price is the true market value. See *infra* notes 72-75 and accompanying text.

**A. Discounts from “Market Price”**

Discounts are no doubt as old as trade, or at least as old as pre-set prices. They raise legal questions only where the discount is illusory or creates deception. Discounts designed merely to induce the sale are puffery and are legal. Reimposable discounts generally take the rhetorical form of puffery and may seem harmless, but they are likely to be illegal penalties. Rent discounts are a good example.

Sunset Apartments advertises special rent concessions for tenants signing leases in the current month. The advertising does not reveal that the special recurs in continuous monthly increments. The pitch is that tenants can enjoy a \$1,000 apartment for only \$800 a month for the twelve-month lease. Clause 5 states that tenant “will pay \$1,000 per month for rent” and further identifies that amount as the “market rent” without defining that term. Clause 10 states that tenant “will receive a \$200 monthly discount making monthly rental rate \$800.” Additional terms state that if the tenant moves out before the end of the lease, the concessions will be forfeited. These rent-concession forfeitures are in addition to other fees specified in the lease, including a “reletting fee” of \$500 that the landlord can claim merely for making the effort at mitigation if tenant moves out early. The lease further requires tenants’ signatures at the end of the lease and their initials at the bottom of each page of the lease.

Mary signs a Sunset lease for a twelve-month term. After ten months, Mary’s employer reassigns her to a job in another state and she has no choice but to leave. Under the law in the state where Sunset Villa is located, Mary owes the rent for the remaining two months if Sunset is unable to relet during that time. Under this law, Mary owes Sunset the remaining two months’ rent of \$1,600 plus a reletting fee of \$500, with a reimbursement owed to Mary if Sunset can relet for any portion of the two months. Sunset is thus entitled to demand \$2,100 from Mary. Instead, Sunset’s demand letter to Mary seeks the remaining two months’ rent at \$1,000 each month, plus \$200 for each of the months Mary lived there, plus the \$500 reletting fee, for a total of \$4,500. Put another way, Mary has breached and now owes \$1,000 rent each month, plus the \$500 reletting fee, minus a credit for the ten payments of \$800 in discounted rent.

**1. Reimposed Rent Concessions as Liquidated Damages**

Sunset’s reimposed higher rent fails up front because it cannot satisfy the widely-used test for liquidated damages. Although the test varies somewhat from state to state, the common principle is that

liquidated damages must be a reasonable estimate of an actual loss that cannot be quantified.<sup>68</sup> Sunset's actual loss can be quantified, and the reimposed market rent is not part of that loss. Clause 5 states that tenant "will pay \$1,000 a month," modified by the language in Clause 10 with the \$200 monthly concession, "making the monthly rent \$800."

What is the rent—\$1000 or \$800? Keeping in mind that the contract language alone does not determine this,<sup>69</sup> the most pertinent point is that the tenant was paying \$800 a month. The tenant was attracted to this apartment with an expectation of paying \$800 a month, in spite of the language that the rent would be \$1,000 a month in the event of breach.<sup>70</sup> Sunset's loss is the amount of rent the tenant would have paid, plus actual bills such as utilities, plus various liquidated fees for reletting and cleaning.<sup>71</sup> If Mary had remained in

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<sup>68</sup> *Stewart*, 245 S.W.2d at 486.

<sup>69</sup> *Id.*

<sup>70</sup> Closely related and undeserving of separate enumeration is the argument that the parties had an agreement. That is, however the lease's terms can be characterized as rent or penalties, the contract is clear on the underlying point—tenants agreed to pay an extra \$2400 in the event of early termination of the twelve-month lease. This conclusion is reached with no regard for law or history, but many consumers apparently believe it. But as with other illegal aspects of contractual agreements, courts ignore penalty clauses. The fact that the parties have agreed is irrelevant. Had the parties not agreed, it would not be a contracted-for penalty. If this argument had any validity, then courts and legislatures would lack power to impose terms on contracting parties, or to declare public policy in regard to contracts. The opposite is true, and that truth extends far outside the single point of contract penalties. See *e.g.*, *Stewart*, 245 S.W.2d at 486 ("Regardless of which line of cases is followed, the courts will not be bound by the language of the parties."). See generally 2 FARNSWORTH, *supra* note 4, §§5.1-5.9 at 1-100.

<sup>71</sup> Most of these contractually-specified damages are uncontroversial, though they may be onerous to the breaching tenant. Other than the rent concession, the other fees are assessments of actual loss to the landlord. Ordinary rent, utilities, repair and clean-up are out-of-pocket losses to the lessor. The reletting fee is not necessarily a measured out-of-pocket loss, but is a valid assessment of liquidated damages. The costs of reletting the premises include advertising and the salaries of employees who answer the phone and show the apartment. Large apartment complexes with continual turnover will bear these costs in any event, merely to promote full occupancy, and without regard to how many tenants left early. While breaching tenants may increase the work for employees, they likely have little impact on the advertising costs for large apartment complexes. Nevertheless, it is fair to spread those costs to the tenants who leave early. The costs, of course, will vary from breach to breach, and while \$824 may seem high, it is an assessment of

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the apartment for the duration of the lease, Sunset would collect twelve installments of \$800 and no more, other than perhaps incidental move-out fees. The \$200 monthly rent concession, adding up to \$2,400 for the twelve-month lease term, is not a part of the performance of this contract. The landlord collects that \$2,400 concession only if the tenant breaches. When tenant moves out early, the landlord's out-of-pocket loss of rent is measured from an \$800 base. Whatever argument that can be made for the rent concession as a damage provision, it is not a measure of any loss suffered by the landlord.

This failure to pass the liquidated damages test does not end Sunset's argument. Landlords and sellers have attempted to evade the liquidated damages test with two related arguments—Mary has agreed to pay the market rent if she breaches, and the discount is a bonus rather than a penalty. Both arguments fail upon cursory examination, as explained in the following subsections.

## 2. The Parties' Agreement—Market Value and List Prices

Sunset argues that Mary is obligated to pay \$1,000 because her signature on the lease acknowledged both that the apartment had a market value of \$1,000, and that she would pay it in the event of breach. The lease did not otherwise define the term "market rent." For economists, the terms "value" and "worth" are not precise terms of art. Economics references, if they define these terms at all, do not provide consistent meanings.<sup>72</sup> Instead, the terms are generic and mean what the speaker wants them to mean in specific contexts. With "value" and "worth" having no fixed meaning, what meaning should be given a contract in which the parties agree that 1) the market rent is \$1,000 a month, 2) but the tenant will pay only \$800 a month, unless 3) the tenant breaches, in which case tenant will pay \$1,000 a month?

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an actual cost to the lessor. As long as courts find it reasonable, it is appropriate liquidated damages under *Stewart*, 245 S.W.2d at 486.

<sup>72</sup> See generally THE MIT DICTIONARY OF MODERN ECONOMICS (David W. Pearce, 4th ed. 1992) (hereinafter MIT DICTIONARY), *passim*; THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Peter Newman ed., Stockton Press 1998) *passim*; WEST'S LAW AND COMMERCIAL DICTIONARY IN FIVE LANGUAGES (1985) (hereinafter WEST'S LAW AND COMMERCIAL DICTIONARY), *passim*. Interestingly, the West reference does provide definitions for "market value" and related terms. The apparent reason for the more precise definition there is that "market value" is a legal term. See [K-Z] WEST'S LAW AND COMMERCIAL DICTIONARY 726-27 (discussing definitions of "value").

If seller believes a good is worth \$1,000 but nobody buys it, then the good is not worth \$1,000. Alternatively, if a buyer believes he should pay only \$500 for a good but no seller will sell at that price, then the buyer is wrong. Although both buyer and seller in this example may validly claim that their disparate value settings are accurate, those conclusions have little meaning outside their subjective views. This approach to value often is called “intrinsic value.”<sup>73</sup> The more objective approach however, is “exchange value,” determined by what the good or service brings in the marketplace.<sup>74</sup> Although data are unavailable to show which meaning of value is more often used to measure damages, there will likely be little argument that exchange value is appropriate for most contract damages. Exchange value is determined when the buyer and seller agree on a price. Of course, that value setting is true only for that one buyer and seller. Aggregate value is determined by a collection of transactions.

If we assume that the Sunset lease’s reference to “market rent” refers to the average rental amount for similar apartments in a given geographic market, this raises an interesting question. Can we believe that the landlord willingly rents an apartment to Mary for \$800 if it will readily rent for \$1000? One argument is that the seller has the option of selling (or renting) at a lower price and may do so for reasons other than maximizing profit. Such motives may occur with individual landlords renting single apartments, but are far less likely in large apartment complexes managed by an agent rather than the owner.

The not-interested-in-profits motive can also be tested by measuring the frequency of rent concessions. How often does the landlord grant one? No data are available on this, but it is significant that the rent-concession language can be found on form leases prepared by residential apartment associations.<sup>75</sup> If Mary’s rent concession is recited in a form agreement, as most large apartment complexes use, it is highly unlikely that Sunset’s concession is

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<sup>73</sup> See MIT DICTIONARY, *supra* note 72 at 446-47 (discussing definitions of “value”); [K-Z] WEST’S LAW AND COMMERCIAL DICTIONARY *supra* note 72, at 726-27 (discussing definitions of “value”).

<sup>74</sup> See MIT Dictionary, *supra* note 72 at 446-47; See also [K-Z] WEST’S LAW AND COMMERCIAL DICTIONARY *supra* note 72, at 726-27.

<sup>75</sup> Leases containing form language for reimposable rent discounts are in the author’s possession. These leases may be available at various apartment-association websites.

limited to Mary or a few other tenants. If instead the rent concession is made to many or most tenants, there are two plausible reasons: puffery and penalties.

Rent concessions, like other discounts from “market price” are good sales pitches—this apartment is worth \$1,000 a month, and if you move in this month, you’ll pay only \$800. A more familiar example is the car dealer who advertises the “list price” as \$20,000, but sells the car for \$16,000. In both cases the puffery is a legal means of inducing the buyer on the promise that this apartment or car is worth something more than the discounted price. But when the discount is reimposed on the sale price as a result of buyer’s breach, resulting in a price that the seller would not have received with routine performance, the discount puffery becomes an illegal penalty.

To the extent that landlords wish to argue market value, reliable data is available. The market value of rental properties can be determined at any given time with data from apartment rentals in a defined area. That is not to say that rent-concession penalties can be validated by market data. To the contrary, they remain penalties because they do not reflect the landlord’s actual losses. But if courts or legislatures choose to view the rent concessions as bonuses rather than penalties, the burden should rest on the landlord to prove market value when seeking damages higher than the rent being paid by the tenant.

### **3. The Bonus Theory**

Another specious argument for reimposed discounts is the bonus theory. It takes the form of the glass-half-empty/glass-half-full paradigm. Upon analysis, however, the glass simply is empty. Suppose that Mary contests the reimposed discount as a penalty. Sunset argues that the rent concession is not a penalty at all, but instead is a bonus. That is, the lease does not impose a penalty for moving out early. Rather, it does the opposite by rewarding the tenant who remains. Instead of a penalty for breach, the reimposed discount is a bonus the tenant has lost.

Professor Avery Katz poses a similar problem to students in his Contracts class. He first asks them whether one can guarantee prompt performance from a building contractor by providing that late performance will result in a 20 percent cut in the price. The students correctly answer that such a penalty would be voidable if the party’s actual damages did not reasonably support the 20 percent claim. Professor Katz then asks them about a 20 percent price cut, and a 20 percent bonus for on-time performance. He reports that students

usually see that simply cutting the price and re-labeling the penalty as a bonus cannot operate as an all-purpose method of evading the penalty doctrine. Katz points out, however, that the question can be more complicated because bonuses as such are legitimate and play valid roles in contract law. He proposes that the distinction between contract bonuses and penalties lies in their function, much as Judge Posner distinguishes between penalties and valid liquidated damages.<sup>76</sup> A true bonus, Katz says, rewards the performing party beyond the contract's fixed consideration for routine performance.<sup>77</sup>

This explanation—bonuses reward beyond the agreement's fixed consideration—does not readily distinguish bonuses from penalties. The distinction is especially difficult in *ad hoc* contracts drawn from scratch, such as an artist's agreement to paint a portrait or a builder's agreement to construct a unique home. It becomes easier in open market consumer contracts. With the Sunset lease, Mary's ordinary performance through the end of the lease term will result in her paying Sunset \$800 a month for twelve months. The bonus is the lower monthly rent of \$800, and the event triggering the bonus is Mary remaining for the full term. If Mary performs her part of the contract, no bonus awaits her. The lease calls for a changed price only if Mary breaches.

The bonus/penalty distinction in Mary's lease can also be made by comparing the lease's terms to similar agreements in a broader market. In other words, if Sunset claims that the \$200 concession is a bonus for an apartment renting for \$1,000, what would that apartment bring in a wider market sample? If the market value is \$1,000 as Sunset maintains, then the \$200 concession is a bonus for Mary. If the market value is \$800, then Mary has not received a bonus but instead faces a \$200 penalty for breach.

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<sup>76</sup> See *Lake River*, 769 F.2d at 1289-93 (finding that a contract's liquidated damages clause acted as a penalty because it overcompensated Lake River).

<sup>77</sup> Email and telephone interviews with Avery Katz, Vice Dean and Milton Handler Professor of Law, Columbia Law School, in New York City, N.Y. (July 28, 2006). Professor Katz further explains that in using market value to distinguish a bonus from a penalty, he would be careful to obtain objective measures outside the parties' viewpoints. Thus, in Mary's case he would accept neither the lease's \$1000 "market rate" nor the parties' actual \$800 transaction rate, but instead would measure market value from a sufficiently large number of similar rentals where the terms did not include the rent concession or other bonus/penalty provisions. Katz points out that a problem occurs even with this objective measure if all sellers in a given market recast their penalties as bonuses; there, he would use the parties' actual transaction price to measure market value. *Id.*

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**B. The No-Interest Pitch**

“Have we got a deal for you—drive a brand new Dynasty XL today, no payments or interest until NEXT YEAR!” On March 1, 2007, National Motors widely advertises an ostensibly limited-time offer—qualified buyers may take immediate possession of the popular Dynasty XL with no money down and no interest or payments until January 1, 2008. The sales contract repeats these terms and adds a clause stating that this discount will be forfeited if the buyer breaches by not having made the first payment by the end of the five-day grace period that runs on January 5, 2008. In other words, if the buyer’s first payment reaches the seller after January 5, 2007, the buyer forfeits the no-interest clause and must pay interest from the date of possession.<sup>78</sup>

On March 3, 2007, John buys a Dynasty XL under this agreement for a transaction price of \$20,000, with no payments due until January 1, 2008. John takes possession of the Dynasty XL immediately and drives it daily through the following December holiday season. National Motors mails the payment schedule to John in October. In the rush of the holiday season, John overlooks the payment due on January 1. He remembers the payment by January 10 and promptly submits it. In addition to the reimposed discount clause, the financing agreement provides the standard clause for late payments with a liquidated damages penalty of a \$25 late fee. John also submits the \$25 fee with his late payment.

On January 15, 2008, John receives a new payment schedule with a letter explaining that his late payment breached the financing agreement and he has forfeited the interest waiver from March 3 through December 31, 2007. John now will have to pay eighteen percent interest<sup>79</sup>—not only through the duration of the financing

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<sup>78</sup> This example is consistent with form contracts in the author’s possession, including those for financing the purchase of furniture, electronic appliances, jewelry, and other goods. This example blurs the line between the car’s retailer and its manufacturer. In new car sales financed by the manufacturer, the true seller is often a franchised dealer distinct from the manufacturer. That distinction is not important here because when the sale is complete, the buyer’s obligation is entirely to the lender, which is National Motors in this example.

<sup>79</sup> The financing agreement on which this hypothetical is based calls for a 26% interest rate following breach. This hypothetical uses the lower eighteen percent rate to avoid readers’ speculation that the higher rate might be illegal under usury laws, which is not this article’s point.

term, but from the time he took possession of the Dynasty XL in July, 2006. Is this a penalty?

The answer lies in the no-interest sales pitch. When John took possession in March, 2007, with no down payment and no payments or interest due until January 1, 2008, National Motors had an outlay, at a minimum, of its investment in the Dynasty XL. Whether that expense was borne from National Motors's own funds or from borrowed funds, that outlay had a cost. In an ordinary transaction where the buyer pays interest, the seller or financing company will profit by charging the buyer more than its own cost in borrowing or advancing the money.

But in this example of nine months' possession with no payment or interest, the seller is not only foregoing the profit on the financing arrangement but is bearing the cost of providing the car for nine months with no immediate return. The cost varies depending on the accounting method,<sup>80</sup> and on whether National used its own funds or borrowed money to underwrite John's nine-month no-cost possession.<sup>81</sup> No matter what the accounting method or whose money was used, National has a cost in providing John with a car for nine months with no payments.

In characterizing the reimposed discount as legal or illegal, the manner in which National's cost is calculated is irrelevant. Whatever the calculation, National clearly had a cost in giving John possession of the car for nine months without payment. This cost necessarily is absorbed in the transaction price of \$20,000.<sup>82</sup> In agreeing to pay \$20,000 beginning on January 1, 2008, John already has paid National's cost in giving him the car for nine months with no payments.

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<sup>80</sup> National's cost could be calculated either on the transaction price of \$20,000, based on the seller foregoing its account receivable for that nine months, or on the lower estimate of National's own cost in manufacturing John's car.

<sup>81</sup> If National used its own funds, then its cost is the interest that money would have drawn in National's bank account. If National uses borrowed money to make its deal with John, then the cost is what it paid for that borrowed money.

<sup>82</sup> In this example, where the seller and financing company are the same, the cost is borne by the seller. If the seller does not finance the sale, then either the seller or the financing party must bear the cost of John's six-month no-payment possession. Unless the finance company is lending money at no charge, the seller bears the cost. Unless the seller intends to lose money on sales, the cost of the financing agreement—the interest on the loan—is absorbed in the sales price, and at a profit.

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National's no-interest sales pitch is inaccurate. There is interest on the borrowed money, no matter how it is accounted for in the sale. That interest is absorbed in the transaction, and the buyer pays it. The no-interest pitch is nothing more than that. It is sales pitch puffery. Because the interest cost of the deferred payment is absorbed in the sales price, the buyer already is paying interest in the original payment. Using the fallacious no-interest sales pitch to impose an additional interest charge is nothing more than imposing a penalty for breach.

**C. Common Policies For Barring Reimposable Discounts**

Sunset's rent concession and National's no-interest car sale seemingly highlight different aspects of the reimposable discount. In spite of apparent distinctions, the two examples are identical. Both are specious attempts to give legal meaning to sales pitches. Sunset's rent is not being discounted, it is simply meeting market demand. The Dynasty XL is not interest free for nine months; John's agreement to pay \$20,000 covers National's cost in furnishing the car. Any of the arguments that applied to one example can be applied to the other, and the policies underlying them are the same.

The more-often-quoted policy is the Anglo-American notion that damages for breach of contract are limited to the promisee's actual loss, and the related injustice of the seller collecting more.<sup>83</sup> A related policy is the efficient breach, the idea contracting parties should not be penalized where changed circumstances require breach.<sup>84</sup> Both policies apply to all contracts, including both consumer and commercial. But a third policy stands out in consumer contracts: sellers should not gain by inducing breach. Penalties by definition increase the seller's profit. As a result, sellers have an interest in making conditions ripe for breach. If it is true that business and society will function better if contract compliance is maximized, consumer penalties can have the opposite effect by rewarding the seller for the buyers' breaches. That is, sellers make more money from a breach than from routine performance.

Of course, the seller will not make more money if the buyer does not pay. That is why the seller has an interest not in promoting

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<sup>83</sup> See *supra* note 64.

<sup>84</sup> See *supra* notes 54 and accompanying text, discussing *Lake River*, 769 F.2d at 1289. See also Katz, *supra* note 60, at 386-87; Goetz & Scott, *supra* note 60, *passim*; Rea, *supra* note 60, *passim*.

fundamental breaches, but in inducing minor breaches where the buyer remains in possession of the product and continues to pay, but pays at a higher price than originally contemplated. These payment deferred and no-interest contracts are the breeding ground for that illicit profit. Moreover, even in instances of fundamental breach where the buyer has forfeited the apartment or car, the seller's demand can be powerful in the hands of collection agencies and credit reporting services. Although there are no demographic studies describing the victims of contract penalties, the practice is best targeted at middle-class consumers who wish to protect their credit.

This is not to argue that all instances of consumer price discounts and deferred interest are inherent penalties. As so many scholars and courts have pointed out, it all depends on the circumstances.<sup>85</sup> On the other hand, Professor Farnsworth's statement comes in handy here. "A provision that simply attempts to add a sum to the injured party's actual damages is ordinarily an obvious penalty."<sup>86</sup> Discounting a purported established price, whether the adjective is "retail," "list," or "market," is a puffery device perhaps as old as commerce itself. In spite of its specious logic that the good or service is worth something other than what buyer and seller agree to, the discount sales pitch is legal and time-honored if limited to that role. But when the seller's enticement becomes the buyer's obligation—when puffery becomes penalty—Farnsworth's categorical statement is on point.

#### IV. Conclusion

Contracts with stipulated damage clauses perform valid functions in fixing the value of actual but difficult-to-quantify losses. The result is a greater likelihood of quick settlement, or if a trial is necessary, greatly facilitated proof of damages. Stipulated damage clauses not addressed to actual losses perform the invalid function of compelling performance, and have been illegal in the Anglo-American legal system for four centuries. Unfortunately, penalty clauses take different shapes and forms and cannot be sufficiently described to bar their use *per se*, but instead must be construed on a

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<sup>85</sup> See 3 FARNSWORTH, *supra* note 4, § 12.18 at 305-08 (discussing the "reasonable amount" requirement when dealing with liquidated damages). See also *Lake River*, 769 F.2d at 1289-93 (finding that liquidated damages acted as a penalty because it overcompensated the party enforcing it).

<sup>86</sup> See 3 FARNSWORTH, *supra* note 4, § 12.18 at 316.

case by case basis.<sup>87</sup> One indicator of illegality is a breach that brings more profit than would routine performance, with the additional profit not reasonably traceable to any loss suffered by the seller. A stronger indicator is the suspect clause expressly inducing performance rather than compensating the non-breaching party's loss. Despite their illegality, penalty clauses appear regularly in commercial litigation between sophisticated litigants. Consumers, however, do not litigate penalty clauses nearly as often. Consumer challenges, moreover, traditionally have focused on late fees or other unreasonable liquidated damages for identified losses.<sup>88</sup>

Reimposable discounts currently do not appear to be a major consumer issue. In spite of the absence of case law, advertising and the author's anecdotal review of various consumer contracts suggest that reimposable discounts now are widespread. Ironically, the unchallenged reimposable discount should be more easily detected than the unreasonably high late fee. Late fees clearly are linked to the seller's actual damage in such things as administrative costs and advertising, while the reimposed discount is nothing more than an alternative purchase price. But whether the reimposed discount is easily detected or not, its effect on the economy, not to mention its impact on individual consumers, will be significant.

Law reform is unnecessary. The rule barring contract penalties is one of the oldest in the common law. It has been consistently upheld, and has been codified into statutes.<sup>89</sup> Cases are not litigated, however, because consumers do not appear to consult attorneys. Reasons may include ignorance, embarrassment, and lack of money.<sup>90</sup> Consumers who do seek legal advice may have an

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<sup>87</sup> See *Lake River*, 769 F.2d at 1290 (finding that a liquidated damages clause actually acted as a penalty).

<sup>88</sup> Reported case law for consumers challenging penalty clauses is small, although a precise count is difficult because the cataloguing systems do not necessarily group these clauses under one heading. Unreasonable late fees (which do not qualify as reimposed discounts) provide some case law. *E.g.*, *Sun Ridge*, 956 P.2d 876 (apartment late fees set aside as penalties); *BMG Direct Mktg., Inc. v. Peake*, 178 S.W.3d 763 (Tex. 2005) (deciding against plaintiffs in a suit over late fees for returns of compact discs ordered through a music club on grounds of voluntary payment). No cases were found challenging reimposed discounts, in spite of key-word and other searches in hard-bound digests, legal data bases, consumer websites, and the internet generally.

<sup>89</sup> See U.C.C. § 2-718 *supra* note 62.

<sup>90</sup> The ignorance is not only an understandable unawareness of the penalty ban, but a belief that the penalty is owed because the contract called for it.

attorney who does not perceive this violation. Whatever the reason, the resulting consumer debt load is unacceptable.

Unlike the typical liquidated damages provisions pointing to administrative expenses or other actual-but-unquantifiable losses, reimposable discounts are *per se* disincentives to breach. When examined in this light, shorn of the rhetoric of contractual obligation, reimposable discounts mimic the harsh *ad terrorem* provisions of medieval contracts and leases. England began rejecting the practice as it emerged from feudalism. We should not allow ignorance or inaccessible legal help to bring it back.

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Embarrassment flows from the breach of contract, even though some consumer contracts may be designed to induce breach and the reimposable discount is added incentive to ripen conditions for non-performance. Lack of money for attorney fees is attributable both to most consumers' income and resources, and to the relatively low dollar amount involved in consumer credit problems. Most penalty-clause litigation involves commercial parties and an amount justifying the dispute. Consumer penalties, on the other hand, often range from a few hundred to a few thousand dollars. That loss, whatever its impact on the breaching consumer does not seem to justify hiring an attorney or filing a claim. Of course, consumers who find themselves as defendants could raise the penalty issue as a defense. But even then consumers tend not to retain counsel and instead either agree to pay or simply default.